FOND OTVORENO DRUŠTVO BIH

International Support Policies to South-East European Countries

Lessons (Not) Learned In B-H

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CHAPTER VII

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THE FINANCIAL SYSTEM OF B-H

1. Characteristics of the Financial System

The financial system of both B-H entities is very rigid and based on just two types of financial institutions: commercial banks and insurance societies. Early this year, there was a total of 55 banks and 25 insurance societies in B-H. As insurance societies are of almost no significance in financing the business sector and the household sector, the only sources of finance for the two are loans from commercial banks and credit lines of international financial institutions or countries interested in participating in the reconstruction and recovery of the B-H economy. In an earlier chapter, I emphasised the fact that reconstruction would have been impossible without the active participation of the international community. These sources are precious, but only a small part (8.4%) was directed towards loans for the business sector.

A very important provision of the Dayton Agreement was to assign to the state level the responsibility for monetary policy, i.e. the introduction of a common B-H currency. The Central Bank of B-H was established on 11 August 1997, and the convertible mark was introduced in June 1998. In September 1999 the convertible mark became the common currency and the only unit for transfer of payments. The hard currency reserve of the Central Bank of B-H continued to grow and reached the level of 1,042 million BAM [convertible mark] on 31 December 2000. During 2000, preparations were accelerated for the greatest undertaking in the financial system of a country in transition - total transfer of the payment system to commercial banks. Officially, the inland payment system was transferred to commercial banks on 5 January 2001. At the moment, 40 banks are licensed for inland payments in B-H (after the introduction of interim management in *Hercegovacka banka*).

The Central Bank of B-H functions on the rules of the currency board, which means that this institution is not authorised to offer loans to commercial banks. Also, pursuant to the Law on the Central Bank of B-H, this institution cannot buy bonds that the B-H government or the governments of the entities may issue. In the currency board system, commercial banks must observe the following rule:

"If commercial bank lends excessively, the borrowers spend the excess, for instance by writing cheques. In the payments system, more funds flow out of the bank than flow into the bank. To prevent the outflow from bankrupting it, a commercial bank holds reserves. The loans of commercial banks are limited by their need to maintain sufficient reserves to enable depositors to convert deposits into reserves on demand and to withstand outflows of reserves through the payments system."[1]

This rule has particularly significant implications for all countries where there are currency boards, as these systems do not include state institutions which may ensure additional solvency of the system or decrease systemic risks. Decrease of systemic risk in a currency board system may be achieved only with an increase in the index of turnover of the current amount of cash in use, i.e. more rapid and more efficient cash transfers. It was exactly for this reason that the reform of payments system was undertaken.

However, the growth of the pace of cash flow may not produce in the short term any effect on the growth of funds available for the decrease of the cost of working capital (short-term loans) nor the creation of a larger deposit base of the commercial banks intended for securing mid-term loans, which would allow the business sector to structure their sources of funding with lower costs (lower interest rates). Another problem is related to the position of

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[1] Henke, Jonung, Schuler, *op.cit, p. 63.*

commercial banks in the process of financial deregulation. Financial deregulation means an abolishment of financial repression, i.e. the removal of state regulations from the financial sector. A consistently implemented financial deregulation practically means that state bodies responsible for economic policy have no influence in setting interest rates, either short or long term, and thus no influence in the cost of sources of funding of the business sector. In a deregulated financial sector, commercial banks are left with the possibility to determine the interest rate freely, depending on the demand for cash, but also to decide freely on interest rates on ordinary deposits and time deposits.

Since the process of financial deregulation is an international phenomenon and since it has already been implemented to a greater or lesser extent in different regions of the world, results of research on the consequences of financial deregulation are quite interesting. In one of the most comprehensive studies of financial deregulation, Williamson and Mahar[2] arrived at the conclusion that in almost all the countries (except for United Kingdom and Switzerland), irrespective of the level of development, the first reaction of commercial banks to financial deregulation was an increase of interest rates deposits, in order to attract more clients. The growth of deposit interest rates inevitably led to a sudden growth of interest rates for loans and a considerable growth of the cost of financing working capital and investments. The increase in the cost of investments produced an aggregate decrease in the overall volume of investments. A drop in the employment rate was a logical consequence. A positive side of financial deregulation was manifested in the growth of effectiveness of individual investments, but also in the aforementioned significant decrease of overall investments.

Results and consequences of financial deregulation in both developed and developing countries are very important for B-H, as B-H has also implemented financial deregulation. The state has no competence in setting interest rates, nor in directing finances based on a set industrial or development policy. The result of this approach to financial deregulation was reflected in the view, supported by a group of foreign experts, that establishment of as many commercial banks as possible should be supported, in order to create a competitive structure which would, following the logic of a developed market, lead to a drop in interest rates. The same position was advocated by international experts regarding the opening of as many small businesses as possible. Namely, I have often heard discussions arguing that a decreasing number of registered small businesses in B-H in the past two years is a negative trend. However, the problem of this position is that it relies on the assumption that there are developed market structures, with a clear role of key state institutions which supervise and ensure the application of laws. Unfortunately, an institutional structure of this type is still absent in B-H, so the application of the said logic in B-H often produces counter-productive results. The view that the financial sector should be allowed to establish as many commercial banks as possible, and that the competition of those banks would lead to a decrease of interest rates in the first four years after the war, did not prove correct, since it implied a low ratio of founding capital, which facilitated the establishment of a large number of banks.

The establishment of a large number of banks with modest capital, seen within the context of application of provisions of the Basle Committee for Banking Risk Management, meant that practically no bank in B-H was able to support a large investment project of a potential multiplication effect on economic growth and employment. Additional negative effects of insufficiently planned financial deregulation in the time period 1995 - early 1999 were manifested in redirection of part of finance approved from credit lines of international financial organisations (the World Bank) or individual countries (USA - USAID), for non-specific, speculative purposes. Finally, the expectation that a large number of banks would produce lower interest rates was not fulfilled until the moment when insolvency reached enormous proportions. One of the intermediate factors of creation of the basis for the enormous growth of insolvency was the approach that loans should only be directed towards business activities with rapid turnover and high profits. Rapid turnover was realised in trade and part of the service industry which involved a more than 50% grey and black market participation in the said period.

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[2] John Williamson, Molly Mahar*, A Survey of Financial Liberalization, Princeton, New Jersey, November 1998.*

It is obvious that this system is not development-oriented, nor can it produce a development stimulus. Linking these problems with the first part of the text (employment), the problem grows proportionately. In the financial system of B-H, there are no institutions which may provide adequate finance to resolve the problems of huge, real and covert unemployment. The problem of insolvency of the business sector causes the withdrawal of commercial banks from financing the business sector and greater focus on offering loans to private citizens. This trend has been particularly evident in the past nine months and is showing no signs of improvement, despite the fact that in the latter half of 2000, three eminent banks (Raiffeisen Bank, Volksbank, BBI) received licenses and started to develop their business. Still, the arrival of these banks is a positive sign and an indicator of possible improvement in business sector finance.

Table 1. Consolidated balance sheet of commercial banks in B-H

- in million BAM

No.	**Assets / Liabilities**	**Federation of B-H**			**Republika Srpska**		
		31/12 1999	**30/6 2000**	**31/12 2000**	**31/12 1999**	**30/6 2000**	**31/12 2000**
	Assets						
1.	Reserve	265	233	267	11	23	22
2.	Hard currency assets	750	815	901	82	101	91
3.	Receivables from government	28	20	23	3	0	6
4.	Receivables from non-financial firms	1,526	1,638	1,663	942	959	960
5.	Receivables from citizens	272	329	379	4	10	22
	TOTAL ASSETS	**2,841**	**3,035**	**3,233**	**1,042**	**1,093**	**1,101**
	LIABILITIES						
6.	General government deposits	84	61	69	52	53	40
7.	Local currency ordinary deposits	482	546	601	103	127	152
8.	Foreign currency ordinary deposits	427	440	487	39	7	66
9.	Local currency time/savings deposits	21	51	65	2	5	11
10.	Foreign currency time/savings deposits	434	449	459	143	82	16
11.	Bonds	0	0	0	9	9	4
12.	Foreign currency liabilities	917	980	1,007	598	672	573
13.	Government funds	0	7	0	0	0	0
14.	Capital accounts	842	783	807	367	334	320
15.	Other (net)	- 366	- 282	- 269	- 271	- 196	- 81
	TOTAL LIABILITIES	**2,841**	**3,035**	**3,233**	**1,042**	**1,093**	**1,101**

Source: Central Bank of B-H, Bulletin 4/2000, pp. 89-95.

Commercial banks are for-profit institutions and they are guided by profit. Naturally, this is an undisputed fact and they will, logically, not approve loans to businesses with no debt servicing capability. The problem is, however, that at the moment there are no private or state institutions in B-H capable of inducing an investment cycle, particularly projects of enterprise restructuring. Therefore, I believe that international financial institutions, in collaboration with renowned international private investment funds, should develop business sector financing schemes, special sources of financing for the restructuring of B-H enterprises. In view of the fact that the Central Bank of B-H will function on the currency board principles until the end of 2002, it would be good to use the authority of the international community and the Governor of the Central Bank of B-H and allow this institution, managed by a foreign expert, to use discretionary rights and influence the regulation of solvency of the system on the basis of the lender of last resort principle. Facilitating this type of solvency management would be very dangerous if the international community was not to support this approach firmly, but on the other hand, maintenance of the existing rigidity increases the danger of chronic systemic insolvency and expensive sources of preservation of solvency. Therefore, this approach would allow the international community to cut down on the systemic solvency risk. This move would not resolve the development problems of B-H economy. Therefore, one of the most important moves of the international community, in collaboration with reputable investment funds, would be the establishment of a joint investment-development fund, in co-operation with IBRD, EBRD, USAID, KfW, IBJ and institutional investors from the US and the EU. The establishment of this institution would mean a considerable decrease of the risk linked with investments in this region (not only B-H, but other countries in the Balkans as well) and the terms of financing and know-how provided by these institutions would allow a decrease in the cost of investment capital and an acceleration of economic growth and employment.

2. Problems Noted in the Financial System

The main problem of the financial system of Bosnia-Herzegovina is its rigidity, i.e. an almost total dependence on the business philosophy of commercial banks. The position of the international community that total financial liberalisation is a necessary precondition of an effective market economy, in conjunction with the possibilities which exist for local authorities to control foreign trade and abuse the state border in order to enjoy unlawful additional profits, have resulted in the establishment of a large number of small banks with modest capital on the one hand, and the orientation of these banks towards business sectors with rapid financial turnover with a significant share held by the grey and black economy on the other.

Financial liberalisation influenced the creation of high interest rates for short-term loans, which decreased considerably the possibility of structuring the sources of finance for working capital of business in a sustainable way. Improvement of financial discipline with the introduction of international standards into banking meant a withdrawal of banks from financing risky projects, defining as risky all projects where there was any late payments on loans. The debt servicing capability of businesses with large number of employees is considerably lower, which is an additional complication of the problem of maintaining current solvency.

The launch of the Central Bank of B-H as a unique institution for all of Bosnia-Herzegovina was undoubtedly a stabilisation factor, in the sense of establishing a common currency and a more effective co-ordination of the entities' banking agencies. However, the principles of currency board which do not allow the Central Bank of B-H to act as a lender of last resort, thus with no possibility of managing financial crisis, removes from this institution the potential to influence the direction of the business cycle and to help solve the insolvency problem.

3. Recommendations

In view of the need to ensure financial discipline on one hand, and the need for financial crisis management in Bosnia-Herzegovina as well as other countries of Southeast Europe on the other, what is needed is that, together with the introduction of a customs union in Southeast Europe and between this region and the EU, there should also be introduced a single monetary institution for all the countries in the region. The single monetary institution might be the Central Bank of SEE countries, with discretionary rights, but also headed by central bankers from developed countries (the European Union, the United States, or a person appointed by international financial institutions) together with representatives of SEE countries. In other words, both in theory and in practice, a central bank with discretionary rights, managed by conservative central bankers, would be the best solution, or at least the next best[3]. The international community would use its authority and appoint a governor, thus elevating significantly the credibility of the institution. A regional central bank could have branches in all SEE countries. A regional central bank would also have the right to buy state bonds pursuant to previous agreements on the issue of public debt between the SEE countries and the IMF. A regional central bank would not appear as the principal buyer of state bonds, but by appearing as a buyer, it would stabilise the bond market and promote more balanced development of capital markets.

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[3] Mervyn King, "Changes in UK monetary policy: Rules and discretion in practice", *Journal of Monetary Economics 39,* Elsevier Science, 1997, pp. 81-97.; taken from: Fikret Čaušević, *Finansijska deregulacija, globalizacija i ekonomska politika,* a doctoral thesis, Sarajevo, May 2001.